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SUBJECT: Argentina Economic and Financial Weekly for the week ending February 24, 2006

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Weekly Highlights
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- The peso was unchanged against the USD, closing again at 3.08 ARP/USD.
- IADB postpones a USD 500 million loan approval for Argentina.
- U.S. Judge rules in favor of two holdout hedge funds.
- Congress approves a bill reforming the Magistrate's Council.
- GOA runs an ARP 1.6 billion primary fiscal surplus in January - lower than expected.
- Private investment increased 30 percent in 2005.
- Commentary of the Week: "The New Inflation Scenario"

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MARKETS
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The peso was unchanged against the USD this week, closing again at 3.08 ARP/USD.
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¶1. The peso remained flat versus the USD this week, closing at 3.08 ARP/USD. Earlier in the week, the peso depreciated one cent to 3.09 ARP/USD after the Central Bank (BCRA) purchased USD 92 million in the FX market on February 21. The BCRA then kept up its active intervention by purchasing a total of USD 175 million and EUR 21 million which were neutralized by increased exporters' sales as well as inflows to purchase domestic bonds. That allowed the peso to recover its lost cent and close the week at 3.08 ARP/USD -- unchanged from last Friday's close. BCRA daily purchases of FX averaged USD 44 million in February, bringing the accumulated purchases to USD 1.5 billion since the beginning of the year. BCRA reserves stand at USD 21.3 billion, as of February 21. The peso exchange rate has depreciated 1 percent since

the beginning of the calendar year.

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ECONOMY / FINANCE
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IADB postpones a USD 500 million loan approval for Argentina.
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¶2. On February 22, the Inter-American Development Bank (IADB) board decided to postpone until March 1 discussions on a USD 500 million loan approval for Argentina. Many IADB representatives asked for more time and details about the specific purpose of the adjustment loan. The GOA expects the IADB will eventually approve the loan. If approved, this loan would be the first adjustment loan received by the GOA without the umbrella of an IMF program. Meanwhile, the World Bank (WB) maintains on hold loans to the GOA for USD 875 million.

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U.S. Judge rules in favor of two holdout hedge funds.
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¶3. Judge Thomas Griesa of the Federal Court for the Southern District of New York ruled in favor of two hedge funds controlled by Greylock Capital. The hedge funds sued the GOA to recover USD 227 million of principal and past-due-interest. In spite of the ruling for the holdouts, it will be difficult to enforce as the GOA has no sovereign assets to be seized.

¶4. Separately, a German Court rejected the GOA argument of financial instability and allowed two holdout investors to continue with their claims. This decision could pave the way for further claims for EUR 1.5 billion, according to press reports.

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GOA considering issuing USD 500 million in international markets.
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¶5. On February 23, business newspaper El Cronista Comercial reported that the GOA is considering tapping international markets as early as mid-March for USD 500 million. The GOA will seek an additional USD 500 million at a later date, depending on market conditions. The new instrument would reportedly be a USD denominated bond issued under U.S. or U.K. legislation, becoming the first issuance under non-domestic law after the debt restructuring. However, this transaction could run the risk of attachment due to the suits pursued by holdout investors. GOA financial needs for 2006 are limited - as low as US 1.5 billion according to some financial analysts.

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Congress approves a bill reforming the Magistrate's Council.
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¶6. On February 22, the Chamber of Deputies approved -- after a nine-hour debate -- a bill to reform the Magistrate's Council. The bill was approved by a vote of 148 to 89. The controversial reform reduced from 20 to 13 the members of members of the Council that is responsible for appointing and removing judges. Before the reform, the Council consisted of eight legislators (four senators and four deputies), 11 legal experts, and one representative of the executive branch. With the reform, the Council will now consist of six congressmen, six legal experts and one representative of the executive. The Senate had

already approved the bill at the end of 2005. Critics of the bill argue that the reform shifts the balance of power in the judicial system in favor of the government, casting doubts on the independence of the judicial system. The approval of this bill -- introduced by Senator Cristina Fernandez de Kirchner, the President's wife -- is viewed as a political victory for President Kirchner and shows that the President is gaining support in the lower Chamber where the administration does not enjoy a majority of seats.

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BCRA accepts bids for a record high of ARP 2.2 billion.
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¶7. The BCRA received bids of ARP 2.4 billion in its February 21 Lebac auction, well above the ARP 1.3 billion in Lebacs that came due during the week. As in the last three auctions, the BCRA was more than able to roll over its maturities by accepting bids for ARP 2.2 billion. The yield on the 42-day Lebac decreased from 6.80% to 6.79%. The yield on the 77-day Lebac dropped 10 basis points to 7.0%. Lebacs for other maturities were withdrawn due to lack of interest. Investors concentrated more than 55% of their bids in Nobacs of more than 9 months and the BCRA accepted bids for ARP 1.2 billion of Nobacs (54% of the accepted amount in the auction). The yield on the nine month Nobac and the two year Nobac remained unchanged at 3.13% and 5.57%, respectively. As in the previous auction, investors are showing interest in Nobacs, since these instruments have a variable rate and provide a higher yield and protection than Lebacs, which have a fixed rate and are no longer issued with

CER (CPI-linked index) adjustment. This shift from Lebacs to Nobacs allows the BCRA to extend the maturity of its liabilities as Nobacs are longer term instruments compared to Lebacs, which were recently issued at very short-terms due to the BCRA's rejection of higher interest rates.

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Bank profits totaled ARP 1.9 billion in 2005.
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¶8. According to a BCRA report, the financial system posted profits of ARP 232 million in December, bringing its accumulated profits to ARP 1.9 billion for 2005. Public bank profits totaled ARP 129 million while private bank profits reached ARP 93 million in December, bringing accumulated profits to ARP 1 billion and ARP 810 million during 2005, respectively. The profits came mainly from interest income due to credit expansion, which demonstrates that the financial system is returning to it core activity. Loans to the private sector increased 37 percent to ARP 46.3 billion in 2005 (compared to a 26 percent increase in 2004).

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GOA runs an ARP 1.6 billion primary fiscal surplus in January - lower than expected.
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¶9. The GOA announced a primary fiscal surplus of ARP 1.6 billion in January, below market expectations of ARP 1.9 billion. In January, fiscal resources increased 30.7 percent y-o-y, at a lower rate than expenditures, which rose 37.1 percent y-o-y. A GOA official argued that the higher growth rate of expenditures is due to stronger investment expenditure. The primary fiscal surplus decreased 2 percent y-o-y. The BCRA consensus forecasts an ARP 22.6 billion primary fiscal surplus for 2006.

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GOA studying increasing the minimum threshold for the income tax.
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¶10. The GOA is studying increasing the minimum threshold for the income tax from ARP 1,835 to ARP 2,400 per month for single employees, and from ARP 2,235 to ARP 3,000 per month for married employees, beginning in April. Taxes are paid on income earned that is above this minimum threshold. According to official estimates, this measure will have an annual fiscal cost of ARP 530 million. Additionally, the GOA stated that will introduce changes to the deductions allowed to compute the income tax, so as to extend the benefits to a larger number of tax payers. However, this move requires Congressional approval since the GOA is not allowed to change the income tax law by an ordinary decree. The GOA is also considering increasing the maximum amount exempt from the assets tax, which has not been revised since the 2001 devaluation in spite of CPI and nominal wage increases since December 2001.

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Private investment increased 30 percent in 2005.
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¶11. According to an INDEC report, total private investments -- Capital Formation and Mergers and Acquisitions - increased 30% y-o-y to USD 14.1 billion in 2005, showing a 368% increase from the 2002 level. Mergers and Acquisitions totaled USD 4.7 billion, while Capital Formation investments reached USD 9.4 billion (67% of the total). The highest investment level was reached in the infrastructure sector, followed by the manufacturing industry and the mining

sector. Foreign investments were mainly concentrated in the manufacturing industry and mining sectors.

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January industrial production index up 4.7 percent y-o-y.
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¶12. The industrial production index increased 4.7 percent y-o-y in January, below the BCRA consensus of 7.8 percent. During January, the fastest-growing sectors were tobacco production (up 13 percent), minerals (up 11.7 percent), and plastic and rubber (up 10.9 percent), which were partially offset by a sharp decrease in car-production (down 42.9 percent). The index decreased 6.4 percent m-o-m non-seasonally adjusted. The disappointing result is mainly explained by the low performance in the automobile industry affected by plant retooling. The BCRA consensus survey forecasts 6.4 percent industrial production growth for 2006.

¶13. The industry-wide capacity utilization index reached 64.9 percent in January, compared to 66.1 percent in January 2005. The sectors showing the highest capacity utilization were oil refining (92.7 percent), metal based industries (84 percent), and paper and cardboard (76.9 percent). The sectors with the lowest capacity utilization were auto production (18 percent), metal-mechanical excluding cars (52.8 percent), and non-metallic minerals (55.7 percent).

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Commentary of the Week: "The New Inflation Scenario" By Manuel Mora y Araujo. [Note: Translated and used with permission of the author, from an article published February 7 in La Cronista Comercial. End Note.]
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¶14. Current inflation is higher than had been expected one or two years ago. The society's inflation tolerance, however, has been better than expected. The correlation between monthly variation in prices and the variation in government approval ratings has practically disappeared. This correlation had been nearly perfect for the last 15 years.

¶15. The reason for the higher inflation is clear: a combination of high growth in the economy, strong internal and external demand, post-crisis realignment of prices, a less tight monetary policy than orthodox policy might suggest and, last but not least, possible collusion or price fixing by companies. Insofar as the majority of analysts stress the first factors mentioned, the government stresses the last one. The government justifies its policy of price agreements in response to private sector collusion, plus the need to manage inflation expectations.

¶16. The reason for society's inflation tolerance, however, is less clear. There are two hypotheses. First, Argentines' memory of inflation is always the 1970's, which ended with the hyperinflation of the end of the 1980's. The end result of that period was stagflation which later affected most of the world. In Argentina, stagflation hit with uncommon force and was probably less tolerable as a result of the stalled-economy component than because of the inflationary component (which is why countries experiencing economic growth where able to tolerate inflation much better). In contrast, the current inflation is accompanied by high rates of growth and a previously unheard-of fiscal surplus and has yet to reach dangerous levels. A majority of the population, moreover, believes the inflation will not reach these levels.

¶17. Second, the current inflation has had a distinct impact on different sectors of society. The majority of formal workers in the private sector during the past three years have had income increases that have exceeded the rise of prices. Although there has not been an increase of subsidies for those in the lowest income brackets, many have found employment that, on average, substantially improves their incomes. In contrast, the middle class, employed in the public or informal sector, is the most affected by rising inflation. The central government's efforts, and practically all of its public communications, are directed to these two sectors to reinforce their trust among the poor and the middle class that the government is working daily to protect them. As long as the economy keeps growing, private incomes keep rising, and trust in the government does not waver, there is no reason to expect that the situation will change or that the government will change its message.

¶18. For the government it is clear that the objective is not to have the lowest possible inflation but rather inflation compatible with high rates of growth.

¶19. Abroad, particularly in the business community, attention is focused primarily on the government's approach to managing a problem before it becomes a problem itself, because that shows how the government will approach future problems. This approach is perceived to be unorthodox and causes concerns; the government's communication effort to generate favorable expectations is insufficient on the inflation front. All indications are, however, that the Government of Argentina is little affected by the business community's concern. The GOA trusts that investment rates will continue to be relatively high and has confidence in the robustness of its fiscal surplus policy.

¶20. It may be taken for granted that high-risk investors who are prepared to operate in competitive unregulated markets will think little of Argentina, no matter what the current government does (without a doubt, that is one reason for the chronically low competitiveness of our economy). Meanwhile, investors that are looking for opportunities in secure niches or in areas with regulated businesses, with high profit and low risk, are driven more by their capacity to lobby (both the Argentine government and their own government, whose support they expect in order to be able to operate in Argentina) than by the uncertainties of the country. For the most part, the Argentine government is not worried about investment flows.

¶21. If the government does not have a low inflation goal, where does it put a limit on what is acceptable? Presumably, it will happen when inflation is on the verge of being uncontrollable or when it becomes intolerable for society and, thus, turns into a political problem.

¶22. In conclusion, Argentina will probably spend the year in the present situation of high growth accompanied by high inflation. This scenario ensures political stability as long as the scenario experiences no significant changes in either of its two elements: high growth must continue, the rate of inflation should not rise. If this scenario were to change for the worse, the consequences would be significant: government policy would have to change or the political climate would have to change. It is unlikely, however, that this latter variant will occur. [Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.]

GUTIERREZ